STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

NORTHERN ILLINOIS GAS COMPANY d/b/a NICOR GAS COMPANY Application for approval of accounting treatment associated with the sale of off-system storage services to third parties.	))))))	No. 01-0439

INITIAL BRIEF OF NICOR GAS COMPANY

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d/b/a Nicor Gas

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Northern Illinois Gas Company, d/b/a Nicor Gas Company ("Nicor Gas" or "Company") respectfully submits its Initial Brief in this proceeding. As explained below, the Commission should approve the Company's proposed below-the-line treatment of expenses and revenues directly related to a Federal Energy Regulatory Commission ("FERC") regulated off-system storage service that would be made possible by the proposed expansion of the Company's Troy Grove natural gas storage field. In conjunction with this approval, the Commission should authorize Nicor Gas to credit $1 million annually to ratepayers until the Company's next rate case.

I. Nicor Gas' Proposed Troy Grove Storage Expansion Project Would Benefit Ratepayers and the Public.

A. Nicor Gas Proposes to Expand Troy Grove's Storage Capacity and Deliverability at No Cost and No Risk to Ratepayers.

Nicor Gas owns and operates seven aquifer storage fields within its service territory, with a top gas storage capacity of 143 Bcf and a total rated peak day deliverability of 2.8 Bcf. The Company generally uses its storage capacity to serve its retail customers. However, from time to time, the Company enters into storage service contracts to provide off-system services to third parties under the provisions of its blanket certificate issued by FERC. Nicor Gas Group Ex. 1, pp. 8-9 (Upshaw Direct). As required by its blanket certificate, the Company only provides third-party, off-system storage services if doing so will not reduce reliability of service to its ratepayers. *Verified Petition*, ¶ 2. Of course, the same standard would apply to the proposed expansion involved in this case.

As the Commission is aware, the Troy Grove storage field is connected to both Natural Gas Pipeline Company of America ("NGPL") and Northern Border Pipeline Company ("Northern Border"), as well as to a Company-owned transmission line. Provided that the Commission approves its proposed accounting treatment, Nicor Gas proposes to expand Troy Grove's daily deliverability by 200,000 MMBtu and its top gas capacity by 5.0 Bcf and to sell the resulting incremental seasonal capacity and daily deliverability off-system as storage service to third parties pursuant to its FERC-issued blanket certificate. Nicor Gas Group Ex. 1, p. 9 (Upshaw Direct).

To expand its Troy Grove storage field for this purpose, while protecting and improving service to ratepayers, the Company would be required to invest approximately $26 million. This investment would include 10,000 horsepower of compression, two dehydration towers, a glycol reboiler, four injection/withdrawal wells, four observation wells, miscellaneous metering and piping, and additional non-recoverable base gas.[1] Nicor Gas Group Ex. 1, p. 9 (Upshaw Direct).

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1 Engineering assessments have determined that Troy Grove requires non-recoverable base gas equal to approximately 28% of its total gas in inventory in order to sustain sufficient pressure to support normal cycled storage volumes. Consequently, to support an additional 5.0 Bcf of top gas inventory, an additional 1.4 Bcf of non-recoverable base gas would be required. Nicor Gas Group Ex. p. 10 (Upshaw Direct).

This investment would be made exclusively with shareholder-supplied funds and, under the Company's proposed accounting treatment, would involve no cost and no risk to ratepayers. Both the level of the investment and the design of the expansion project reflect the Company's strong commitment to protect and improve service to its ratepayers, while simultaneously offering a valuable new service to benefit the public and gas marketers.

B. The Troy Grove Expansion Project Would Enable the Company to Offer Marketers a Flexible New Multi-Cycle Storage Service.

The expansion project, if undertaken, would enable Nicor Gas to provide a unique multi-cycle storage service that is wholly incremental to any existing services offered by the Company. This proposed storage service would utilize operational capabilities resulting from expansion of Troy Grove while preserving, protecting, and improving the Company's existing storage capability for the benefit of Nicor Gas' ratepayers. Nicor Gas Group Ex. 1, pp. 10, 14 (Upshaw Direct).

When injecting or withdrawing supplies into or from Troy Grove's expanded storage, shippers would take receipts or deliveries from NGPL or Northern Border. Firm receipts (injections to storage) would be available from either pipeline, and firm deliveries (withdrawals from storage) could be made to NGPL. These firm receipts and deliveries would be provided to the interstate market by means of firm transportation under the Company's FERC blanket certificate. Nicor Gas Group Ex. 1, p. 11 (Upshaw Direct).

The terms and operating parameters for the new storage service are contained in the Term Sheet attached to Mr. Upshaw's direct testimony (Nicor Gas Group Ex. 1) as Exhibit LWU-1. To ensure that the storage rights of existing ratepayers would be preserved and protected, the new multi-cycle service would require shippers to adhere to specific operating parameters, or ratchets. These parameters would establish shippers' daily withdrawal rights, based on the month and on the current day's level of storage inventory. For example, when inventory is 50% of contract volume or less, reduced volumes would be available to be withdrawn from storage. Conversely, when storage exceeds 50% of contract volume inventory, shippers would have more gas available for withdrawal on a daily basis. The maximum withdrawal rate, assuming contract volume inventory is greater than 50%, would be 200,000 MMBtu per day. Further, withdrawals would be capped at no more than four times the applicable maximum daily withdrawal during any five-day period, and the applicable maximum withdrawal could only be taken for three days in a row during any five-day period. Nicor Gas Group Ex. 1, pp. 11-12 and LWU-1 (Upshaw Direct).

These withdrawal parameters were designed, first and foremost, to ensure that sufficient incremental inventory remains in the reservoir at all times to maintain the pressure necessary to preserve deliverability to current ratepayers. In addition, the withdrawal parameters were designed to be similar to those offered by interstate pipelines and other storage providers, but with a minimum number of ratchets. The injection rights under the new service were also designed to mirror the current injection capabilities of Troy Grove, and conform to the same operating profile utilized by the Company in serving its on-system sales and transportation customers. Nicor Gas Group Ex. 1, pp. 12-13 (Upshaw Direct).

During critical days, firm deliveries into NGPL would be accepted. However, the Company's FERC blanket certificate, which would govern the service, requires that not be the best-cost alternative to support on-system peak requirements. Nicor Gas Group Ex. 1, pp. 15-16 (Upshaw Direct).

The Company also considered whether there were alternatives to a transmission investment that could enable it to cost-effectively use the proposed Troy Grove expansion to serve on-system customers. For example, Nicor Gas could purchase incremental firm interstate pipeline capacity to haul the additional deliverability from Troy Grove to a different portion of the Company's system to support peak day requirements. However, the Company concluded that the combined costs of the $26 million storage investment and additional interstate pipeline capacity would not result in a best-cost alternative for ratepayers, compared to other options available to meet peak day requirements. Nicor Gas Group Ex. 1, p. 16 (Upshaw Direct).

In addition, the Company concluded that expansion of Troy Grove for on-system use would not promote other important supply planning objectives. Nicor Gas designs its supply portfolio around customer demands under peak day conditions. The Company's on-system aquifer storage fields are not operationally able to deliver at or near each field's peak rated capacity for more than a limited number of days per year, and must be managed to sustain the pressure required to meet peak design day requirements as late as January 20. Pipeline transportation capacity, on the other hand, is capable of delivering the contracted amount each day of the year. Since on-system storage and pipeline transportation capacity provide different types of flexibility in managing the Company's system and meeting on-going demand requirements, Nicor Gas must have a balanced supply portfolio. Moreover, effective supply management requires diversification of supply sources. By increasing reliance on on-system storage to cover peak day storage services sold to third parties not interfere with any firm, on-system obligations to ratepayers. Nicor Gas would, of course, comply with this requirement at all times. Nicor Gas Group Ex. 1, p. 12 (Upshaw Direct).

C. While The Expanded Storage Capacity at Troy Grove Would Not Meet the Company's Best Cost Supply Criteria For On-System Customers, It Would be Cost-Effective for Third-Party Marketers.

Before determining that the expanded capacity available at Troy Grove should be offered as an off-system service, the Company carefully considered operational and economic issues, as well as market conditions. As a result of this analysis, Nicor Gas concluded that the expanded storage capacity would not be economically used and useful or the best-cost alternative for providing service to existing utility customers.

To support its on-system peak day requirements, Nicor Gas requires a combination of on-system storage, long haul pipeline capacity, peaking supplies and city gate purchases. The Company thoroughly considers many factors, including cost, reliability and security of supply to determine the best alternative for meeting its on-system needs. Nicor Gas' existing transmission line from the Troy Grove storage field is already utilized at full capacity under peak design day conditions. Consequently, the Company could not use the proposed additional 200,000 MMBtu of deliverability from expansion of Troy Grove to directly support on-system requirements unless it also made an additional investment, estimated to be approximately $37 million, to develop sufficient additional capacity in Nicor Gas' transmission system. Without this additional investment, the Company could not directly deliver incremental supply from Troy Grove to serve on-system demand. However, with the additional $37 million transmission investment, the $26 million investment in storage necessary to expand Troy Grove would requirements, the Company would decrease its flexibility to purchase other supply alternatives such as city gate supply, peaking services, or production area gas supply. Consequently, the Company concluded that expansion of Troy Grove to meet on-system requirements would limit its purchasing options and restrict its flexibility in managing price risk. Nicor Gas Group Ex. 1, pp. 16-17 (Upshaw Direct).

The Company's economic analysis of on-system use of the proposed expanded Troy Grove storage capacity is summarized on confidential Exhibit LWU-2, attached to the Direct Testimony of Mr. Upshaw (Nicor Gas Group Ex. 1.1). This table compares (1) the cost of using the expanded 200,000 MMBtu of storage deliverability on-system with additional transmission construction; (2) the cost of using the capacity on-system with the purchase of additional interstate pipeline capacity; and (3) expected market costs of several alternatives for meeting on-system requirements. Even taking into account the seasonal arbitrage value of the expanded top gas storage capacity, Nicor Gas' analysis concludes that expansion of Troy Grove for on-system use would not yield the best cost alternative compared to other supply resources and services. Nicor Gas Group Ex. 1, pp. 18-20 and Ex. 1.1 (Upshaw Direct). This conclusion has not been disputed by Staff.

While expansion of Troy Grove would not be cost effective for the Company's on-system use, Nicor Gas believes that it may be economically feasible for use by gas marketers for at least three reasons. First, because they serve on a national scale, across state and local distribution company boundaries, marketers have a much broader and more diverse market base than does Nicor Gas, which affords them economies of scope and scale that the Company cannot replicate. Second, because marketers do not design their portfolios around the ability to cover peak day demand requirements, as Nicor Gas must do to fulfill its service obligations to its ratepayers, national marketers can and do hold a much larger portfolio of diverse storage and transportation assets, and leverage these assets to capture profits from price volatility. A multi-cycle storage service such as the Company proposes to offer is favored by marketers because its cycling flexibility allows them to capture price spreads. Finally, marketers have a different risk profile than the Company. For example, marketers can absorb a significantly higher level of risk than Nicor Gas, since the returns that they can potentially earn are not capped by regulation. Nicor Gas Group Ex. 1, pp. 7-8 (Upshaw Direct).

The value to marketers of the multi-cycling storage service that Nicor Gas proposes to offer is undisputed by Staff and is evident from the response to the Company's solicitation for service requests. ICC Staff Ex. 2.0, p. 17 (Anderson Direct). To date, the Company has entered into an agreement to provide 3.5 Bcf of storage (out of the total expansion capacity of 5 Bcf) to one non-affiliated marketer for a term of five years, subject to the outcome of this proceeding. Nicor Gas believes it can successfully market the remaining capacity related to the proposed expansion pursuant to its blanket certificate, provided that the Commission approves the accounting treatment sought in this proceeding. Nicor Gas Group Ex. 1, p. 13 (Upshaw Direct). Of course, if the Company is unable to market the remaining capacity at an adequate revenue level, and over the estimated 30 year life of the project, the risk would fall entirely on Nicor Gas' shareholders under the Company's proposal.

D. The Proposed Troy Grove Expansion Project Would Promote the Public Interest.

Upon completion of the Troy Grove expansion project, Nicor Gas would be able to provide a multi-cycle storage service pursuant to its FERC-issued blanket certificate.

This new service would promote the public interest by responding to the needs of emerging natural gas markets in Illinois.

For example, several natural gas fired electric generation plants have been constructed in northern Illinois during the past few years, and there are numerous proposals for additional electric generation facilities to be constructed over the next three to five years to meet the growing electricity demand in Illinois. These facilities, however, require unique supply services to operate. Natural gas fired generation facilities have highly variable load requirements. They typically start up almost instantaneously and consume large amounts of gas during periods of peak electric demand. The short-notice and high deliverability load requirements of electric generation plants necessitate storage balancing services, usually of a multi-cycle variety such as the service the Company proposes to offer. Nicor Gas' proposed expansion of Troy Grove storage and the multi-cycle service that the Company proposes to offer under its FERC blanket certificate would help meet the operational needs of these facilities. Nicor Gas Group Ex. 1, p. 5 (Upshaw Direct).

In addition, several new interstate pipelines have commenced service within Nicor Gas' service territory, and others have recently secured certificates from FERC to begin construction. Nicor Gas has interconnections with two of these pipelines, Northern Border and Alliance Pipeline, which have begun service, and will have an interconnection with Horizon, which was recently certificated. An interconnection with Guardian Pipeline is also possible in the future. These new interstate pipelines do not provide adequate balancing services for power generation customers. Moreover, additional electric generation may be served by these pipelines, increasing the need for balancing services. Nicor Gas Group Ex. 1, p. 5 (Upshaw Direct).

In recognition of the need for balancing service options for interstate pipeline shippers, FERC has encouraged pipelines to allow shippers to manage load requirements through the use of third-party balancing services. Regulation of Short-Term Natural Gas Transportation Services and Regulation of Interstate Natural Gas Transportation Services, FERC Stats. & Regs. Regulations Preambles (July 1996-December 2000) ¶ 31,091 (Feb. 9, 2000); order on rehearing, Order No. 637-A, FERC Stats. & Regs. Regulations Preambles (July 1996-December 2000) ¶ 31,099 (May 19, 2000); reh'g denied, Order No. 637-B, 92 FERC ¶ 61,062 (2000). The multi-cycle storage service that Nicor Gas proposes to offer would provide such a service for shippers on these pipelines. By enabling the Company to offer this service, the proposed Troy Grove expansion project would increase off-system flexibility and enhance utilization of existing interstate pipeline infrastructure, which in turn would improve the level and variety of energy services available in the marketplace. Nicor Gas Group Ex. 1, p. 5-6 (Upshaw Direct).

In fact, the Illinois Energy Workshop, co-hosted in April of 2001 by the Office of the Governor and Argonne National Laboratory, recognized the importance of developing precisely the kind of additional gas storage in Illinois that the Company's proposed Troy Grove expansion would enable Nicor Gas to provide.[2] On the issue of reducing natural gas price volatility, the Workshop Report concluded that "[t]he State should encourage the construction of additional market area storage to accommodate an

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2 Chairman Mathias was a panelist at this conference, and several Commission Staff members were participants. See Report of the Illinois Energy Workshop: Electricity and Natural Gas, pp. 19-21, 60-63.

expanding gas market, including non-conventional loads, such as power generation." Report at 59.

Nicor Gas has been a leader in the State in recognizing that, as the choice of gas suppliers is extended to more customers and as new market segments emerge, new products and services must be offered to meet the needs of customers and their suppliers. Indeed, Staff also recognizes that the Company's proposal to expand Troy Grove and offer the resulting incremental capacity pursuant to its FERC-approved blanket certificate would provide a valuable tool to gas marketers to serve these developing markets, where enhanced flexibility equates to customer benefits. ICC Staff Ex. 2.0, pp. 16-17 (Anderson Direct); see Nicor Gas Group Ex. 1, pp. 6-7 (Upshaw Direct); Nicor Gas Group Ex. 2, p. 8 (Upshaw Rebuttal).

E. The Proposed Troy Grove Expansion Project Would Benefit Ratepayers.

Nicor Gas ratepayers would also benefit from the proposed expansion of Troy Grove storage in several ways. First, Nicor Gas is offering a substantial financial benefit to ratepayers by proposing to credit annually $1,000,000 to ratepayers through the purchased gas adjustment clause until the conclusion of the Company's next rate case. Nicor Gas Group Ex. 8; Staff Group Ex. 1 (POL-1.07). While such a credit would significantly increase the Company's investment risk and significantly lower its expected return, Nicor Gas is willing to provide the credit to remove any conceivable concern about the immediate and substantial benefits that this project would provide to ratepayers. Nicor Gas Group Ex. 2, p. 3 (Upshaw Rebuttal); Nicor Gas Group Ex. 5, pp. 4-5 (Harms Rebuttal).

Second, ratepayers would benefit directly from increased operational efficiency and reliability of Troy Grove storage as a result of the expansion project. These operational efficiencies would result from installation of additional compression and surface facilities, contractual withdrawal limitations on third-party storage customers that permit use of unutilized facilities for the benefit of ratepayers, winter injections by third-party storage customers, and higher inventory balances that would help to sustain pressures and allow for increased field performance. Verified Petition at ¶ 15; Nicor Gas Group Ex. 1, p. 14 (Upshaw Direct); Nicor Gas Group Ex. 7. Significantly, these benefits would accrue to ratepayers even though no costs related to the expansion would be allocated to or recovered from them under the Company's proposal. Nicor Gas Group Ex. 1, p. 14 (Upshaw Direct).

Third, as explained above, the proposed storage expansion project would promote further development of a competitive gas market and construction of additional electric generation plants in Nicor Gas' service territory. The dynamics of the energy industry over the past few years have demonstrated the need to offer a variety of products and services that meet changing market conditions. By responding to the needs of third-party marketers that serve the small customer transportation market, the power generation market, and other emerging markets, Nicor Gas' proposed multi-cycle storage project would enhance market options and lower prices for its ratepayers, as well as the public as a whole. Nicor Gas Group Ex. 1, pp. 6-7, 14 (Upshaw Direct); Nicor Gas Group Ex. 4, p. 2 (Harms Direct).

Fourth, in addition to the $1 million annual credit described above, the proposed expansion would provide a direct financial benefit to ratepayers over the long term because some of the Company's pre-existing costs and overheads would be allocated to the expansion project. Consequently, the proposed project would help to delay the Company's need for future rate relief and would lower revenue requirements to be recovered from ratepayers in future rate proceedings. Nicor Gas Group Ex. 4, p. 2 (Harms Direct).

Specifically, under the Company's proposed accounting treatment, Nicor Gas would remove $377,300 in annual operating and maintenance costs, depreciation and return on a portion of rate base assets from revenue requirements during its next general rate case. In addition, customers would avoid providing approximately $550,800 in return and depreciation on a $4 million capital outlay that would most likely be classified as utility property if the Troy Grove project did not proceed. Nicor Gas Group Ex. 5, pp. 3-4 (Harms Rebuttal). This would be another significant ratepayer benefit from any reasonable perspective.

II. <u>The Company's Below-the-Line Accounting Treatment Proposal Should Be Approved.</u>

Pursuant to the Commission's Order in Nicor Gas' last general rate case, Docket No. 95-0219, the Company is currently required to account for revenues generated by off-system storage services as a credit to gas supply costs. In this proceeding, Nicor Gas requests that the Commission determine that this accounting treatment is inapplicable to revenues specifically generated by off-system sales of storage under the Company's FERC-approved blanket certificate made possible by expansion of the Troy Grove storage field.

A. The Accounting Authority Requested Would Allocate All Costs and All Risk to the Company.

The Company requests that the Commission authorize it to record revenues generated as a result of the Troy Grove expansion project as below-the-line non-public utility revenues. Such revenues would be accounted for separately from all other off-system storage service revenue, which would continue to be treated as provided in the Commission's Order in Docket No. 95-0219. In addition, all fully distributed expenses related to the expansion project would be transferred below the line, and associated capital expenditures would be classified as non-public utility property.

If this accounting treatment is approved, Nicor Gas' shareholders would absorb all financial risks associated with the expansion project. Nicor Gas Group Ex. 4, pp. 3, 6 (Harms Direct). And, because all revenue and incremental and allocated expenses related to the expansion project would be accounted for separately, consistent with 83 Ill. Adm. Code Part 506, these costs and revenues would be excluded from future rate relief requests.[3] Nicor Gas Group Ex. 4, p. 6 (Harms Direct).

This accounting treatment is both necessary and appropriate to encourage the type of innovative investment that would be involved in the proposed expansion project, and to align the financial rewards that could potentially be derived from the project with the financial risks that would be borne exclusively by Nicor Gas' shareholders under the Company's proposal. By accounting for all costs associated with the project as non-public utility costs, the Company would assume all financial risk of the project and would

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[3] Due to the unique nature of the storage service that would be offered as a result of the proposed Troy Grove expansion, with its specific operating parameters, the Company and the Commission could readily distinguish those revenues from other off-system storage revenue. Nicor Gas Group Ex. 4, p. 6 (Harms Direct).

be solely responsible for achieving a return on its investment, at rates regulated by FERC. Nicor Gas Ex. 4, p. 3 (Harms Direct).

The Company's proposed accounting treatment, if approved by the Commission, would create a win-win-win situation for ratepayers, the public, and the Company's shareholders. As explained above, ratepayers would receive direct and indirect benefits from the project at no cost, and ratepayers and the general public would receive multiple benefits with the overarching protection of FERC regulation. Shareholders, who would provide the required investment with no long-term assurance that the storage service will be subscribed to at adequate revenue levels over the estimated 30 year life of the project, would be afforded the opportunity to achieve a reasonable return on their investment. Nicor Gas Group Ex. 4, p. 4 (Harms Direct). No other approach would achieve these objectives.

B. Only Below-the-Line Accounting Treatment Would Provide an Appropriate Incentive for the Level of New Investment Required By the Proposed Troy Grove Expansion.

The circumstances that led the Commission to require that off-system storage revenue be included in gas supply costs in the Company's last general rate case were markedly different than the circumstances involved in this proceeding. Specifically, at the time of the Company's 1996 rate case, it was uncertain whether Nicor Gas would be able to generate levels of revenue from off-system storage agreements in the future comparable to those it had generated during the rate case test year. Recognizing this uncertainty, rather than establishing a fixed value for off-system storage revenue, the Commission adopted Staff's alternate proposal. Consequently, as a compromise, the Commission's order removed from the rate case test year data all revenue related to then-existing off-system storage agreements, and directed that future revenues from these sources be treated as a credit in the Company's Rider 6 gas supply cost calculation. Nicor Gas Group Ex. 4, p. 4 (Harms Direct).

It is important to recognize, however, that the storage services offered and contemplated at the time of the 1996 rate case exclusively utilized existing facilities that were included in the rate base adopted by the Commission in that proceeding and did not require or contemplate any incremental investment. Nicor Gas Group Ex. 4, pp. 4-5 (Harms Direct). The storage service that would be offered if Troy Grove were expanded, in contrast, would require a major (i.e., $26 million) incremental investment. Thus, while the compromise adopted by the Commission was reasonable in the context of the 1996 general rate case, the associated accounting treatment did not contemplate a project like the one proposed here, and was not designed to provide any incentive whatsoever to invest in storage expansion projects to serve off-system markets. What this means is that, unless the Commission adopts different accounting treatment to encourage this expansion project, where a substantial incremental investment is required, no such projects will be, or rationally could be, undertaken. Nicor Gas Group Ex. 4, p. 5 (Harms Direct); Nicor Gas Group Ex. 2, pp. 3-4 (Upshaw Rebuttal).

Nor is the Company's performance-based rate ("PBR") mechanism appropriate for allocating revenue from an investment in a storage expansion project such as the one proposed by the Company. Under Nicor Gas' PBR, approved by the Commission in Docket No. 99-0127, the Company is allowed to retain 50% of gas cost savings, as compared to a designated benchmark. While this mechanism could theoretically permit the Company to retain 50% of any revenues generated by off-system storage projects, the

PBR is not an appropriate vehicle for addressing the accounting treatment for this investment.

The reasons for this are clear. While a sharing mechanism such as the PBR is appropriate for balancing ratepayer and shareholder interests in the context of managing current gas expenses, it does not and cannot provide a reasonable balance of risk and reward over the life of a project such as the Troy Grove expansion that would require a $26 million capital investment. Moreover, by statute the Company's current PBR is subject to review and possible revision or elimination.[4] Moreover, allocating only 50% of the revenue from this project to shareholders--who would bear 100% of the $26 million in capital costs--would render the investment imprudent, as a matter of simple economics. Thus, the PBR is inherently a short-term mechanism with an uncertain future. The Troy Grove expansion project, on the other hand, has an expected useful life of over 30 years. Consequently, even if the 50% sharing mechanism offered an appropriate incentive for undertaking minor capital projects, it suffers from a serious potential timing mismatch for major long-term investment by Nicor shareholders, such as that involved here. Nicor Gas Group Ex. 4, p. 5 (Harms Direct).

Despite Staff's opposition to the Company's request for below-the-line accounting treatment, it is important to recognize that neither Nicor Gas nor any other utility could responsibly undertake a comparable capital project unless the Commission addresses the proper accounting treatment for off-system storage revenues from capital intensive

4 The Company notes that the Commission has initiated a review of Nicor Gas' PBR, as it is required to do under Section 9-244(c) of the Public Utilities Act, in Docket No. 02-0067. Depending on the results of that review, there may or may not be a PBR in place by the end of 2002, and it is not possible to know what form any such PBR might take.

expansion projects like Troy Grove. As explained above, the direct investment of $26 million by Nicor Gas would not be prudent to serve on-system customers because there are better and lower cost alternatives to meet their requirements. Moreover, the investment would be imprudent from a shareholder perspective under the current accounting requirements specified in the 1996 rate case order (which requirements were established under totally different circumstances) because shareholders would be subject to all the financial risk while realizing at best only a partial return (under the PBR) or no return on their investment. Nicor Gas Group Ex. 2, pp. 2-4 (Upshaw Rebuttal). In short, the future of the proposed Troy Grove expansion project --and all the benefits that it indisputedly would provide to ratepayers and the general public--depends on Commission approval of accounting treatment that realistically aligns the potential return with the associated risk.[5]

III. The Company's Proposed Allocation of Costs Associated with the Project is Fair and Reasonable.

The Company's current investment in on-system storage, as well as its expenses and allowed return on rate base, are included in base rates and recovered from ratepayers through Nicor Gas' distribution charges. Nicor Gas Group Ex. 1, p. 8 (Upshaw Direct); ICC Staff Ex. 1.0, p. 6 (Iannello Direct). In contrast, the storage services that would be offered in conjunction with the proposed Troy Grove expansion would be available only because of new incremental investments in Troy Grove that were not included and could

[5] While the Company has offered a $1 million annual credit to ratepayers, as described above, and has made it clear that it is open to a reasonable alternative to or modification of its accounting proposal, Staff has consistently and unfortunately maintained that the Company's accounting proposal should be flatly rejected. See ICC Staff Ex. 1.0, p. 20 (Iannello Direct); ICC Staff Ex. 2.0, pp. 23-24 (Anderson Direct); ICC Staff Ex. 5.0, p. 21 (Iannello Rebuttal).

not have been included in rate base in the Company's last general rate case in 1996. Consequently, ratepayers have not paid and would not pay rates reflecting any of the incremental costs that would be incurred in connection with the expansion project. Nicor Gas Group Ex. 4, pp. 6-7 (Harms Direct). Moreover, the Company commits that it will not propose to include the investment or any expenses associated with the proposed expansion in future rate cases, if the accounting authority it has requested in this proceeding is granted. Nicor Gas Group Ex. 4, p. 7 (Harms Direct).

Of course, because the Troy Grove project would involve expansion of existing storage facilities used to serve the Company's on-system customers, some of the assets that would be utilized in connection with the proposed storage service are obviously reflected in Nicor Gas' base rates. However, under the Company's proposal, Nicor Gas has committed to fairly and properly allocate fully distributed costs related to the off-system storage service to the expansion project and to record them below-the-line, ensuring both that on-system customers would not pay for such costs, and that the Company's revenue requirements would be reduced in a future rate case. Nicor Gas Group Ex. 4, p. 7 (Harms Direct).

Staff witness Anderson contends, however, that because the proposed off-system storage service would utilize "co-mingled" regulated and unregulated assets, the proposed expansion could result in ratepayer subsidization of the non-utility storage service. ICC Staff Ex. 2.0, pp. 7-15 (Anderson Direct). Although he does not propose an alternative, Mr. Anderson also claims that the Company's proposed method of cost allocation does not adequately reflect the actual operating costs of regulated utility and non-utility functions and would not prevent utility subsidization of the non-utility storage service. ICC Staff Ex. 2.0, pp. 18-19 (Anderson Direct).

Staff's suspicions of utility malfeasance and imprudence are, however, wholly speculative and unwarranted. For costs that can be tied directly to the expansion project, such as operating and maintenance expenses of the new compressor and dehydration facilities, Nicor Gas proposes to directly transfer the cost below the line, and there could obviously be no question of cross-subsidization. Nicor Gas Group Ex. 5, p. 2 (Harms Rebuttal); Staff Group Ex. 1 (ENG 1.8). For joint costs that are common to utility and non-utility storage services, the Company proposes to base its allocation on the percentage increase in top gas capacity that would be added to the Troy Grove storage field as a result of the expansion project, which is approximately 10 percent (5 Bcf / 48.1 Bcf.). Nicor Gas Group Ex. 5, pp. 2-3 (Harms Rebuttal). Staff Group Ex. 1 (ENG 1.8, 1.9). This is an entirely reasonable approach.

Moreover, despite Staff's aversion to the concept, there is nothing unusual or nefarious about "co-mingling" utility and non-utility assets, or the Company's proposed cost allocation methodology. In fact, this type of co-mingling and allocation are wholly consistent with 83 Ill. Adm. Code Part 506, which provides for cost allocation of shared facilities that are used to provide both utility and non-utility services. If joint use of utility and non-utility facilities were improper, as Staff asserts, there would be no need for Part 506, which clearly contemplates use of shared facilities. Nicor Gas Group Ex. 5, p. 3 (Harms Rebuttal); Nicor Gas Group Ex. 6, p. 4 (Harms Surrebuttal). In any event, while Staff has made the unsubstantiated claim that the Company's proposed allocation methodology is "suspect" (ICC Staff Ex. 2.0, p. 19 (Anderson Direct)), it has not proposed any changes to that method nor suggested any alternate allocation method. Nicor Gas Group Ex. 6, p. 2 (Harms Surrebuttal). Staff's "Just Say No" approach is contrary to the public interest and should be rejected.

IV. Off-System Storage Transactions via Displacement Would Not Increase Gas Costs or Complicate Cost Allocations.

Staff further contends that, by using displacement, rather than physical transactions, in offering the proposed off-system storage service, Nicor Gas could somehow utilize the operating flexibility created by its utility operations for the benefit of the non-utility storage service. ICC Staff Ex. 1.0, pp. 12-16 (Iannello Direct); ICC Staff Ex. 2.0, p. 21 (Anderson Direct). Similarly, Mr. Anderson argues that the use of displacement transactions would "complicate" the allocation of operating costs between regulated and non-utility operations to the point that a reasonable allocation would be "difficult." ICC Staff Ex. 2.0, p. 22 (Anderson Direct). In addition, Mr. Iannello contends that displacement transactions or shifting of purchases would somehow increase gas costs to ratepayers. ICC Staff Ex. 1.0, p. 16 (Iannello Direct); ICC Staff Ex. 5.0, p. 7 (Iannello Rebuttal).

These purported concerns are utterly speculative, unreasonable and unwarranted. First, under the terms of the storage service agreement that would be offered to customers if the Company's proposal is approved, Nicor Gas' revenues would be generated from fixed demand charges, and the Company thus could not receive additional revenues by altering pipeline receipt points. Staff Group Ex. 1P (ENG 1.18 Confidential). In other words, the Company would receive essentially a fixed stream of revenue regardless of where the gas covered by the agreement is delivered into the system. Accordingly, moving gas from one pipeline to another, as Mr. Iannello hypothesizes could happen, would objectively not result in the Company receiving more revenue from the off-system storage service. Consequently, contrary to Mr. Iannello's speculation, there is absolutely no financial incentive for the Company to engage in the kind of "displacement" or purchase-shifting transactions that Mr. Iannello apparently (and hypothetically) contemplates. Nicor Gas Group Ex. 6, pp. 5-6 (Harms Surrebuttal); Nicor Gas Group Ex. 3, pp. 4-5 (Upshaw Surrebuttal).

Second, Nicor Gas' off-system storage agreement would limit the off-system customer to primary receipt points on NGPL or Northern Border. These two pipelines interconnect directly with Nicor Gas at the Troy Grove storage facility. Therefore, if the off-system customer sought to deliver gas to Nicor Gas from any other pipeline, and that action could potentially increase ratepayers' gas costs, the Company could and would refuse the receipt. Alternatively, if such volumes would reduce on-system ratepayers' supply costs, Nicor Gas would have the option to accept such volumes. Nicor Gas Group Ex. 3, p. 5 (Upshaw Surrebuttal).

Third, displacement, as the term is used by the Company with respect to the proposed off-system storage service, means the switching of gas supply deliveries from storage to direct distribution to customers, or vice-versa. Through use of displacement, Nicor Gas would not change the amount of gas it purchases from various pipelines, as with or without displacement the same quantity of gas would be purchased by the Company and delivered through the same pipelines. Displacement--again, as that term is used by the Company--only affects the proportion of the delivered gas that is injected into storage, as compared with the proportion that is delivered directly to end users. Consequently, displacement could not have any impact on Nicor Gas' gas supply costs.

Nicor Gas Group Ex. 5, pp. 5-6 (Harms Rebuttal). Indeed, Mr. Iannello's concern actually addresses the hypothetical shifting of gas purchases in a manner that would increase gas costs. While it is true that shifting of gas purchases could theoretically have this effect, it has nothing to do with displacement (as the Company uses the term to describe the switching of gas deliveries between storage and sendout) or with how the Company's proposed off-system storage service would actually operate. Nicor Gas Group Ex. 5, pp. 6-7 (Harms Rebuttal).

Fourth, with respect to Mr. Iannello's concern, Illinois utilities--including Nicor Gas--have a strong and objective incentive not to shift purchases in a manner that would increase gas costs. This is because shifting of purchases in such a manner would violate 83 Ill. Adm. Code 525.40(d), and the Commission could, should and undoubtedly would disallow the costs of any such transactions. Nicor Gas Group Ex. 5, p. 7 (Harms Rebuttal). Moreover, during more than 20 years of prudence reviews of Nicor Gas' supply purchasing practices, Staff has never even raised a concern about shifts in purchases or alleged that the Company's gas costs were increased by "displacement" or shifts in purchasing activities. Of course, Staff's witnesses in this case have not even attempted to explain why the Company would suddenly deviate from its long history of responsible conduct, and it simply would not do so. Nicor Gas Group Ex. 6, pp. 5-6 (Harms Surrebuttal). Furthermore, it is an objective fact that the Company recovers almost $1 billion annually in gas costs under its Rider 6, Gas Supply Costs. Thus, it would make no sense at all, even if Nicor Gas had a bad intent (which it does not), for the Company to jeopardize the recovery of $1 billion of gas supply costs so as to somehow "game" the incremental benefits of the Troy Grove off-system storage service. Nicor Gas Group Ex. 6, p. 6 (Harms Surrebuttal).

Fifth, Nicor Gas' existing PBR provides a very strong incentive not to increase gas costs. In fact, the very purpose of the PBR is to provide the Company with an incentive to reduce gas supply costs and for Nicor Gas and its customers to each share in a portion of that reduction as compared to a market-based benchmark. Obviously, if the Company were to act in the manner that Staff hypothesizes, thereby increasing gas supply costs to ratepayers, it would automatically reduce shareholder benefits under the PBR. Nicor Gas Group Ex. 5, pp. 7-8 (Harms Rebuttal). This would make no sense.

Sixth, Nicor Gas would only use displacement (as it defines that term) in the first place if it enhanced operation of the system and improved the effectiveness of moving gas. Nicor Gas Group Ex. 2, p. 7 (Upshaw Rebuttal). Moreover, under FERC regulation, which governs the Company's blanket certificate under which the storage services would be offered, sales of off-system storage services that interfere with on-system obligations to ratepayers are prohibited. Nicor Gas Group Ex. 1, p. 12 (Upshaw Direct). There is no reason to believe that Nicor Gas would violate the terms of its blanket certificate, and it simply would not do so.

Finally, Mr. Iannello's illustration of the hypothetical impact of shifting of purchases on gas supply costs (ICC Staff Ex. 1.0, pp. 12-17) is not only irrelevant to Nicor Gas' use of displacement in providing off-system storage, but is also based on unrealistic and erroneous assumptions. Among other shortcomings, his illustration ignores the tendency of competitive markets to eliminate arbitrage opportunities, erroneously assumes that deliveries from an off-system storage customer would force the

Company to reduce purchases on a low-cost pipeline, and mistakenly assumes that a customer's deliveries over a specific pipeline would require the Company to decrease its own deliveries. Nicor Gas Group Ex. 5, p. 8-9 (Harms Rebuttal). These assumptions do not reflect reality.

In short, Staff's claims that what it refers to as displacement transactions utilized as part of the Company's proposed off-system storage service would increase gas costs to traditional utility customers are utterly and objectively baseless and should be rejected.

V. Nicor Gas has No Incentive to Cross-Subsidize Off-System Storage Services.

Staff witness Iannello takes the further position that the accounting treatment sought by the Company would provide an inappropriate incentive for the Company to use ratepayer assets to maximize revenues from the proposed non-utility storage service. He contends that the ability to retain all revenues from the proposed service would encourage the Company to use the flexibility of on-system storage capacity to lower the cost and provide additional service to off-system customers, whose demands are elastic relative to those of ratepayers. Moreover, Mr. Iannello asserts that cross-subsidization of this sort would be difficult for the Commission to detect. ICC Staff Ex. 1.0, pp. 8-12 (Iannello Direct); ICC Staff Ex. 5.0, pp. 11-14 (Iannello Rebuttal). Staff concludes by claiming that flowing off-system revenues through the purchased gas adjustment clause is the only way to ensure that Nicor Gas would not have an incentive to cross-subsidize. ICC Staff Ex. 5.0, pp. 12-13 (Iannello Rebuttal).

Staff's reasoning is seriously flawed for several reasons. First, as Mr. Harms explained, the potential for cross-subsidization simply does not exist. Mr. Iannello's testimony fails to explain credibly just how the Company would be able to use its storage system to lower costs, or to provide additional services, to off-system customers. In fact, the Troy Grove expansion would provide only a finite amount of new capacity, and the FERC-regulated sales that would result from the proposed expansion could readily be tracked by the Commission. The Company would have to charge enough for off-system storage service to recover all the costs allocated to the project, or Nicor Gas would lose money. Since the Company proposes to record all revenues and all expenses associated with the expansion project--including those allocated from utility services--below the line, the Commission would have no difficulty reviewing the associated revenues and costs to ensure that no cross-subsidization occurs. Nicor Gas Group Ex. 5, p. 9 (Harms Rebuttal).

Second, Staff's claimed inability to detect inappropriate actions by a utility should not, in itself, be a basis for rejecting innovative proposals. Indeed, if the Commission accepted Staff's argument on this point, it would establish a policy under which utility innovation and creativity would be per se constrained by the self-proclaimed limitations of Staff, regardless of the substantive merit of the proposal or the validity of Staff's claim that the proposal is somehow not subject to reasonable review. Nicor Gas Group Ex. 2, pp. 12-13 (Upshaw Rebuttal).

Third, Mr. Iannello's concerns about cross-subsidization are pure and unsubstantiated speculation. In fact, during the more than 20 years in which the Company's gas purchase practices were subject to annual prudence reviews, none of its gas purchases were ever determined to be imprudent. Nicor Gas Group Ex. 6, p. 5 (Harms Surrebuttal). Staff's baseless speculation about possible cross-subsidization should be rejected in light of the Company's long track record of responsible and prudent management of its gas supplies (and, for that matter, all of its costs), for the benefit of ratepayers.

VI. **Conclusion.**

The Company proposes to expand its Troy Grove storage facility to enable it to serve emerging segments of the natural gas market under its FERC-approved blanket certificate. This innovative storage service proposal would offer numerous benefits to the general public and the Company's ratepayers, including promotion of the evolving competitive supply of natural gas to smaller customers in the Company's service area, and crediting of $1 million annually to ratepayers through the purchased gas adjustment clause until the Company's next general rate case. Nicor Gas is willing to take the full financial risk of the project, but can responsibly do so only if it is provided with a reasonable opportunity to earn a fair return on its investment. To make this possible, the Company requests in this proceeding that the Commission approve its proposal to record the costs and revenues of the expansion project and off-system storage service below the line. Only if it receives such authority (or is offered a reasonable alternative to that proposal) will the Company have a reasonable economic incentive to make the $26 million investment that would be required to expand its aquifer storage facility at Troy Grove. For all the reasons explained in this brief and the testimony of the Company's witnesses, the Commission should approve Nicor Gas' proposed accounting treatment, and its proposal to credit $1 million annually to ratepayers until the Company's next rate case.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I, Stephen J. Mattson, an attorney, hereby certify that I caused copies of the Initial Brief of Nicor Gas Company to be served on all parties listed on the attached service list by E-Mail and United States mail, first class, postage prepaid on February 21, 2001.

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